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In the

Supreme Court of the United States

October Term, 1948

No. [redacted]

INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statute and regulations involved	2
Statement	3
Specification of error to be urged	5
Reasons for granting the writ	5
Conclusion	15
Appendix	16

CITATIONS

CASES:

Commissioner v. *Munter*, 331 U. S. 210	8, 10, 11, 12, 14
Commissioner v. *Sansome*, 60 F. 2d 931, certiorari denied, 287 U. S. 667	8
Commissioner v. *Wheeler*, 324 U. S. 542, rehearing denied, 325 U. S. 892	11, 12, 13, 14
Cranson v. *United States*, decided Nov. 12, 1943, affirmed 151 F. 2d 1021	7, 14
Crimson v. *United States*, 146 F. 2d 871, certiorari denied, 326 U. S. 717	6, 7, 8, 9
Crocker v. *Commissioner*, 29 B. T. A. 773	10
Harter v. *Helvering*, 79 F. 2d 12	9
Helvering v. *Credit Alliance Corp.*, 122 F. 2d 361, affirmed, 316 U. S. 107	9
Putnam v. *United States*, 149 F. 2d 721	11
Reed Drug Co. v. *Commissioner*, 130 F. 2d 288	11
Robinette v. *Commissioner*, 148 F. 2d 513	9
Senior Investment Corp. v. *Commissioner*, 2 T. C. 124	10

STATUTES:

Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Sec. 22	5, 16
Sec. 112	12, 13, 14, 16
Sec. 113	16
Sec. 115	4, 17
Second Revenue Act of 1940, c. 757, 54 Stat. 974, Sec. 501	13, 14

MISCELLANEOUS:

H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41, 42 (1940-2 Cum. Bull. 496, 526-527)	14
1 Mertens, Law of Federal Income Taxation, Sec. 9.30	10
S. Rep. No. 2114, Part 1, 76th Cong., 3d Sess., p. 25 (1940-2 Cum. Bull. 528, 546-547)	14
Treasury Regulations 94, Art. 115-3	12, 13, 18
Treasury Regulations 101, Art. 115-11	9

IN THE

Supreme Court of the United States

OCTOBER TERM, 1947

No.

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

MARGARET R. PHIPPS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT.

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Tenth Circuit entered in this case.

OPINIONS BELOW

The opinion of the Tax Court (R. 13-23) is reported at 8 T.C. 190, and the opinion of the Circuit Court of Appeals (R. 30-37) is reported at 167 F. 2d 117.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 10, 1948 (R. 38). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The question is whether a cash distribution by a corporation during 1937 to its stockholders, of which the taxpayer received a *pro rata* share, was made from the corporation's accumulated earnings or profits, to the extent that the distribution was not covered by the current earnings for the year 1937, and was consequently taxable as a dividend under Sections 22(a) and 115(a) of the Revenue Act of 1936. The answer to this question turns on whether or not the corporation's own accumulated earnings or profits as of December 31, 1936, were eliminated by the deficits of its wholly owned subsidiaries, the assets of which were transferred in 1936 to the corporation in complete liquidations which were tax-free under Section 112(b)(6) of the Revenue Act of 1936.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations are printed in the Appendix, *infra*, pp. 16-18.

STATEMENT

All the facts were stipulated (R. 10-13) and were found by the Tax Court as stipulated (R. 14). They may be summarized as follows:

During 1937 the taxpayer, a preferred stockholder of Nevada-California Electric Corporation (hereinafter referred to as "parent corporation"), received a cash distribution on her shares in the amount of $18,480. Her cost basis, for tax purposes, for the stock was in excess of the distribution in 1937. (R. 10.)

The distribution to the taxpayer was part of a total distribution of $802,284 made *pro rata* by the parent corporation in 1937 to its preferred stockholders. The parent corporation had earnings or profits for the year 1937 of $390,387.02, and 48.6595% of the distribution in 1937 was chargeable to these earnings. (R. 11.)

On December 1, 1936, the parent corporation liquidated five of its wholly owned subsidiaries by distributing to itself all of their assets, subject to liabilities, in complete cancellation and redemption of all of their outstanding stock. No gain or loss was recognized on the liquidations for income tax purposes under Section 112(b)(6) of the Revenue Act of 1936. (R. 11-12.)

On December 1, 1936, one of the liquidated subsidiaries had earnings or profits accumulated after February 28, 1913, in the amount of $90,362.77, and the four other liquidated subsidiaries had

deficits in accumulated earnings or profits which aggregated $3,147,803.62 (R. 12).

On December 31, 1936, the parent corporation had earnings or profits accumulated after February 28, 1913, in the amount of $2,129,957.81. This amount does not include or reflect either the accumulated earnings of the one subsidiary or the deficits of the four subsidiaries, or the earnings or losses of the subsidiaries (R. 12-13).

In her income tax return for 1937 the taxpayer reported the entire amount of $18,480 distributed to her in that year as a taxable dividend but later filed a claim for refund of part of the tax paid for 1937 on the ground that the amount was not a taxable dividend (R. 10). The Commissioner determined that the distribution constituted taxable income in its entirety and so advised the taxpayer in the deficiency letter, which proposed a deficiency in income tax for 1937 resulting from adjustments not here in controversy (R. 6-7, 11).

In the Tax Court the taxpayer conceded that the distribution was a taxable dividend to the extent (48.6595%, or $8,992.28) that it was paid from current earnings for 1937[1] (R. 14). As to the

[1] Section 115(a) of the Revenue Act of 1936 (Appendix, *infra*) defines a dividend for tax purposes as a distribution by a corporation to its shareholders out of (1) its earnings or profits accumulated after February 28, 1913, or (2) the earnings of the taxable year (computed as of the close of the year), without regard to the accumulated earnings and profits at the time the distribution was made and Section 115(b) of the Act (Appendix, *infra*) declares that every distribution

balance of the distribution the Tax Court held[2] that it was not a taxable dividend paid out of the parent corporation's earnings accumulated after February 28, 1913, because all of its accumulated earnings of $2,129,957.81 as of December 31, 1936, plus the accumulated earnings of $90,362.77 of the one subsidiary, were eliminated by the deficits, aggregating $3,147,803.62, of the four subsidiaries (R. 16-23).

The Circuit Court of Appeals affirmed, Judge Huxman dissenting (R. 30-37).

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that the accumulated earnings or profits of the parent corporation at the end of 1936 were extinguished, for taxable dividend purposes, by the deficits of its subsidiaries, the net assets of which the parent acquired during 1936 in tax-free liquidations of the subsidiaries.

REASONS FOR GRANTING THE WRIT

1. The decision of the Circuit Court of Appeals is in conflict with that of the Circuit Court of Ap-

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is from the most recently accumulated earnings or profits to the extent thereof. It was therefore properly conceded that 48.6595% of the total distribution was a dividend paid from current earnings and taxable to the shareholders as such under Section 22(a) of the Revenue Act of 1936 (Appendix, *infra*).

[2] The opinion of the Tax Court written by Judge Disney was not reviewed by the whole Tax Court.

peals for the Ninth Circuit in *Cranson* v. *United States*, 146 F. 2d 871, certiorari denied, 326 U.S. 717. Although the lower court stated (R. 32) that the court in the *Cranson* case did not pass upon the question whether the deficits of subsidiaries carry over to extinguish the accumulated earnings of a parent corporation, which acquires the assets of the subsidiaries in tax-free liquidations, the record in the *Cranson* case, which was before this Court on petition for certiorari, No. 85, 1945 Term, shows that that precise point was decided by the Ninth Circuit Court of Appeals contrary to the decision of the same point by the court below.

In the *Cranson* case, pursuant to tax-free complete liquidations in 1936, a parent corporation acquired the net assets of three wholly owned subsidiaries, which together had an aggregate operating deficit of $1,205,451.61. Later in 1936 the parent made a distribution of $1 per share to its stockholders, total $937,743. (R. 38, No. 85, 1945 Term.) The parent's earnings for the year 1936 were $931,553.82 and its accumulated earnings at the beginning of the year 1936 were $139,631.26. It was there contended that the aggregate operating deficit of the subsidiaries, or alternatively the losses sustained by the parent on the liquidations (which were slightly in excess of the deficits), cancelled out both the current earnings of the parent for 1936 and its accumulated earnings at

the beginning of the year. In holding that the entire distribution of $937,743 in 1936 was a taxable dividend the Ninth Circuit Court of Appeals decided first that the parent's earnings of $931,553.82 for 1936 were not eliminated by either the deficits of, or the losses on liquidation of, the subsidiaries and thus remained as a source for payment of dividends; and second that the accumulated earnings of the parent at the beginning of 1936 were likewise not erased by the deficits of, or the losses on liquidation of, the subsidiaries and thus remained as a source for payment of the part ($6,189.18) of the total distribution which was not covered by the current earnings.[3] The latter holding is expressed in the final paragraph of the Ninth Circuit's opinion, where the court said (p. 872)—

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[3] In a subsequent case involving a distribution by the parent in 1938 this holding was reaffirmed. *Cranson* v. *United States* (N. D. Calif.), decided November 12, 1943 (32 A. F. T. R. 1640), affirmed *per curiam*, 151 F. 2d 1021 (C. C. A. 9th). The parent again distributed $937,743 in 1938, a year in which its current earnings or profits were only $695,694.64. The excess ($242,048.36) of the distribution over current earnings represented a taxable dividend only if the parent's accumulated earnings or profits survived intact after the 1936 transaction in which it had liquidated the three subsidiaries having deficits. The District Court held that neither the accumulated earnings nor the current earnings of the parent had been wiped out by the deficits of the subsidiaries or by the losses sustained by the parent upon the liquidations, and this was affirmed *per curiam* on appeal pursuant to stipulation that the final decision in *Cranson* v. *United States*, 146 F. 2d 871, certiorari denied, 326 U. S. 717, would be controlling.

> It being admitted that $931,553.82 earnings or profits were made in 1936 by the parent corporation and besides it had on hand undistributed profits of $139,631.26, the total amount exceeding that distributed to the stockholders, they were held properly by the tax court to be taxable as dividends to the distributees, of which the appellant is one. * * *

In any event, the court's holding that the entire distribution was a taxable dividend necessarily decided that the accumulated earnings were not eliminated in the transaction since the current earnings were not sufficient alone to cover the whole distribution. Further, the briefs filed in support of, and in opposition to, the petition for certiorari in this Court (No. 85, 1945 Term) argued the correctness of the Ninth Circuit's holding that the deficits of the subsidiaries did not extinguish either the accumulated or the current earnings of the parent. It follows that the Circuit Court of Appeals for the Ninth Circuit decided the same question upon substantially identical facts as is involved in this case in direct conflict with the judgment of the lower court on the question.

2. The judgment of the Circuit Court of Appeals misapplies the so-called "Sansome" principle in violation of the reasoning of this Court in *Commissioner* v. *Munter*, 331 U. S. 210. *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2), certiorari denied, 287 U. S. 667, first stated the rule, which is now firmly established (*Commissioner* v. *Munter*,

supra) that where one corporation acquires all the assets of another corporation, or corporations, in a tax-free reorganization, the accumulated earnings or profits of the predecessor corporation or corporations, which are transferred as a part of the assets, remain earnings or profits in the acquiring corporation's hands and are available for distribution as dividends by it, despite the fact that it may have capitalized the earnings on its books. The same principle applies to transfer intact to the parent corporation the accumulated earnings or profits of its subsidiary corporations, the assets of which it acquires in tax-free liquidations. *Robinette* v. *Commissioner*, 148 F. 2d 513 (C. C. A. 9); *Helvering* v. *Credit Alliance Corp.*, 122 F. 2d 361 (C. C. A. 4), affirmed, 316 U. S. 107; Article 115-11 of Treasury Regulations 101, which although promulgated under the Revenue Act of 1938 applies the rule to a distribution of assets pursuant to a liquidation made in any year. Apart from the decision in this case, however, the *Sansome* doctrine has never been held applicable to carry over, as such, the deficit of a predecessor or liquidated corporation, to a successor or parent corporation, which acquires its assets,[4] and *Cranson* v. *United*

[4] *Harter* v. *Helvering*, 79 F. 2d 12 (C. C. A. 2) on which the Tax Court and the lower court relied (R. 17-19, 32), did not apply the *Sansome* rule to a deficit. As Judge Huxman dissenting pointed out (R. 35-36), the *Harter* case presented the typical *Sansome* situation in which corporations acquired the assets of predecessor corporations which had accumulated earnings or profits. While the Boxboard Company, which

States, *supra*, as already shown, denies that the rule applies to deficits, which of course are the antithesis of earnings or profits. There are all-persuasive reasons why the *Sansome* doctrine should not be extended to permit the inheritance of a deficit by a corporation acquiring the assets of the deficit corporation.

First, the extension of the *Sansome* rule to deficits achieves a result in conflict with the rationale of *Commissioner* v. *Munter*, 331 U. S. 210. There the Court emphasized that the *Sansome* doctrine is required to carry out the basic Congressional purpose that corporate earnings or profits are to be taxed as dividends when they are distributed. If

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acquired the assets of the new company in the final transaction in that case, itself had a deficit, the new company, the assets of which Boxboard acquired, did not have a deficit but on the contrary accumulated earnings. These earnings were held to be acquired by Boxboard as earnings and to remain earnings in its hands. It is true that these acquired earnings had to be applied to restore Boxboard's deficit before Boxboard could have any accumulated earnings available for dividend purposes (cf. 1 Mertens, Law of Federal Income Taxation, Sec. 9.30), but this merely confirms the fact that Boxboard used the acquired earnings as earnings. The situation in the present case is quite the reverse, since the parent corporation acquired the assets of corporations which were without accumulated earnings but which had bookkeeping deficits. As will be shown, these deficits (unlike the case in which the liquidated corporation has accumulated earnings) were not acquired in any sense by the parent corporation.

Cf. also *Senior Investment Corp.* v. *Commissioner*, 2 T. C. 124, petition for review dismissed February 5, 1947 (C. C. A. 6), and *Crocker* v. *Commissioner*, 20 B. T. A. 773, neither of which decided the question here.

a parent corporation is permitted to treat its own earnings as erased by the book deficits of other corporations, the assets of which it acquires, it is enabled to distribute its earnings to its stockholders without dividend tax liability, the very result which the *Sansome* rule, as applied in the *Munter* case, interdicts. An assumed continuation of the liquidated subsidiaries in the parent corporation is not alone a compelling reason for extending the *Sansome* principle to deficits, as the lower court thought (R. 31-32). The decisive factor in applying the doctrine to accumulated earnings or profits is not that the old corporation continues unchanged in the new, since the principle applies to transferred earnings or profits, even where the acquiring corporation is not a mere continuation of its predecessor (e.g., *Commissioner* v. *Munter*, *supra*; *Putnam* v. *United States*, 149 F. 2d 721 (C. C. A. 1); *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6)); but on the contrary the impelling reason for the rule is in the need for preventing the disappearance of accumulated earnings in a transaction in which those earnings are not deemed to have been distributed as taxable dividends. *Commissioner* v. *Munter*, *supra*; cf. *Commissioner* v. *Wheeler*, 324 U. S. 542, 546, rehearing denied, 325 U. S. 892.

Second, where a liquidated corporation has accumulated earnings, its assets represent capital in part and accumulated earnings, or surplus, in part.

Upon liquidation the parent corporation actually acquires the accumulated earnings in the form of property, and in order to insure taxation of the earnings as dividends upon distribution, the property so acquired is deemed to retain its character as earnings in the parent corporation's hands. *Commissioner* v. *Munter*, 331 U. S. 210. It does not, however, conform to reality to attempt to apply the same principle to deficits. Where the liquidated corporation has a deficit, none of its assets represent earnings or profits, but instead all of the assets represent its remaining unimpaired capital. Thus, the parent corporation, upon receipt of the assets on liquidation, does not acquire the deficit in the form of property, nor is the deficit transferred to the parent in an accounting sense.[5] Further, the assets acquired by the parent already constitute capital in their entirety with the result that

[5] For accounting purposes the parent receives assets and to the extent that their value might be less than the parent's investment in the stock, the parent would realize a loss, which would reduce its earnings or profits. The deficit on the subsidiary's books, as such, would not affect the parent's earnings. For tax purposes, however, any loss realized by the parent would not be recognized for tax purposes and would not reduce the parent's accumulated earnings. Section 112(b)(6), Revenue Act of 1936 (Appendix, *infra*); Article 115-3 of Treasury Regulations 94 (Appendix, *infra*); *Commissioner* v. *Wheeler*, 324 U. S. 542, rehearing denied, 325 U. S. 892. The record in this case does not show whether the parent corporation had losses or gains on the liquidation of its subsidiary corporations.

the *Sansome* rule, which operates to prevent the conversion of accumulated earnings or profits into capital in a tax-free transfer, actually has nothing upon which to operate.

Third, as Judge Huxman, dissenting, pointed out (R. 34-35), to treat a deficit as eliminating the parent's accumulated earnings would amount to an indirect frustration of the Congressional policy to postpone any recognition for tax purposes of the transaction until the assets acquired by the parent are disposed of. As already noted (fn. 5, *supra*), a loss, if any, sustained by a parent upon a complete liquidation of a subsidiary would not be deductible for tax purposes (Section 112(b)(6), Revenue Act of 1936, Appendix, *infra*) and would not be permitted to reduce the parent's accumulated earnings (Article 115-3 of Treasury Regulations 94, Appendix, *infra*; Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, which adopted the provision of the regulation for application to all prior years; *Commissioner* v. *Wheeler*, *supra*). Any such loss would, however, presumably derive wholly or in part from the fact that the subsidiary's capital had been impaired as a result of its deficits. It follows that to permit the subsidiary's book deficit to affect the earnings account of the parent would allow indirectly the deduction from the parent's earnings of all or part of the loss sustained on the liquidation, the very thing prohibited by the regulation and the subse-

quently enacted statute." In *Commissioner* v. *Wheeler*, *supra*, pp. 546-547, this Court, although concerned with a different problem, definitely rejected such a result.

3. The question in this case is an important one, which should be settled by this Court. Similar questions are presented in several cases now pending in the Tax Court and the District Courts, and the question will be a recurring one. For administrative purposes it is essential to have the proper rule declared, particularly in view of the presently existing conflict between this case and *Cranson* v. *United States*, *supra*. The administrative interest is emphasized by the fact that the decision of the Circuit Court of Appeals in this case may

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[6] Similarly, a gain to a parent corporation upon the liquidation of a subsidiary would not be recognized to it under Section 112(b)(6) and would not be reflected in the earnings account for tax purposes. Nevertheless, the *Sansome* rule operates to transfer the accumulated earnings or profits of the subsidiary to the parent as earnings. This principle, limited to earnings or profits, does not however run counter to the Congressional intent, for as pointed out in *Commissioner* v. *Munter*, *supra*, p. 215, Congress has repeatedly approved the rule in connection with earnings and in fact did so again in conjunction with enacting Section 501 of the Second Revenue Act of 1940 (H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41, 42 (1940-2 Cum. Bull. 496, 526-527); S. Rep. No. 2114, Part 1, 76th Cong., 3d Sess., p. 25, (1940-2 Cum. Bull. 528, 546-547)) which provides that an unrecognized gain or loss should not increase or decrease earnings or profits. Furthermore, the application of the *Sansome* doctrine to accumulated earnings or profits is justified by the need of preventing tax avoidance, a consideration not present when the assets of a deficit corporation are acquired.

lead to tax avoidance. For example, a corporation having large accumulated earnings might attempt to wipe them out on paper by acquiring (presumably at nominal cost) the stock of a deficit corporation, liquidating it, and offsetting the deficit against its own earnings; it could then, in effect, seek to make a tax-free distribution of those earnings.[7]

CONCLUSION

For the foregoing reasons it is respectfully submitted that the petition for a writ of certiorari should be granted.

PHILIP B. PERLMAN,
Solicitor General.

June, 1948.

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[7] The record in this case does not show whether the parent corporation bought the stock of the liquidated subsidiaries before any of their deficits were incurred or at some later date.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * *

(b) *Exchanges Solely in Kind.*—

* * *

(6) *Property Received by Corporation On Complete Liquidation Of Another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. * * *

* * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * *

(15) *Property Received By a Corporation On Complete Liquidation of Another.* If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112(b)(6), then the basis shall be the same as it would be in the hands of the transferor.

* * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203(a)(3) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free

distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 115-3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. * * *

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